

Once the recovery commences, the potential exists for another policy conflict. Large deficits may compete with private demands for credit as the economy gradually moves toward full employment. If the monetary authorities return to targeting slower growth in money aggregates, competing demands for credit may lead to increased interest rate pressures through 1988. Whether growth can be sustained under these conditions is questionable.

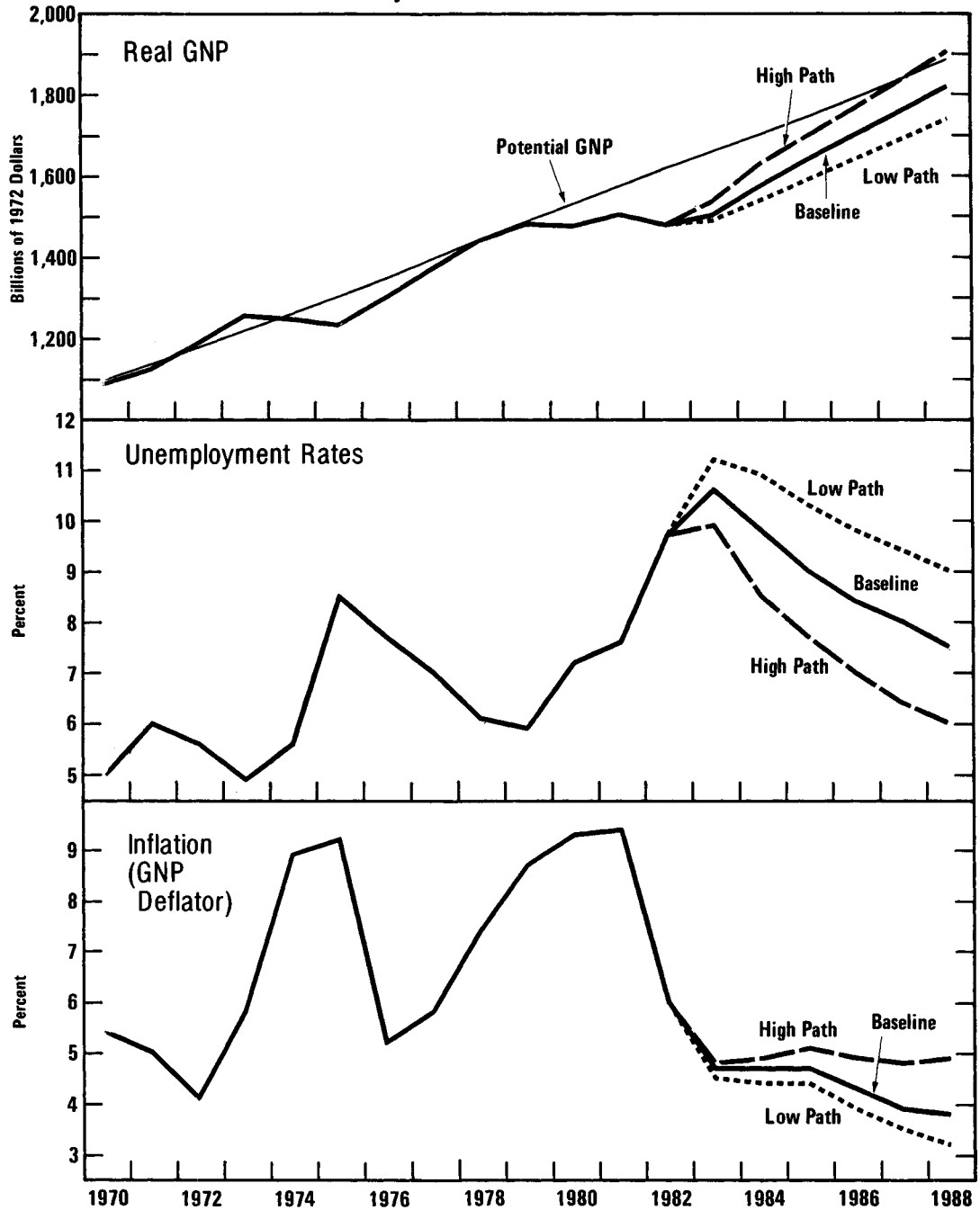
The major uncertainties in the outlook, then, center on possible changes in federal policy and whether they will support a smooth and sustained recovery. Other uncertainties arise from conditions in the world economy. Three related issues are of concern to the forecast:

- o The outlook for oil prices is uncertain. The inability of OPEC to reach a firm agreement on oil prices during its meeting in January, suggests that oil prices may actually fall somewhat over the near term. Although some businesses and countries might suffer, a decline in oil prices would improve the domestic inflation outlook still further and probably cause a pick-up in world economic growth. Another sharp rise in oil prices is, of course, still possible, particularly later in the decade, and continues to represent an inflation risk.
- o The exchange rate, which has risen faster and further than most forecasters expected, might also fall more than anticipated. CBO expects the exchange rate to fall by 10 to 15 percent over the forecast period. Ultimately, such a drop would raise domestic prices by 1 to 1½ percent, but would improve U.S. competitiveness in world markets. A sharper decline cannot be ruled out, however, and further declines may occur later in the decade--putting additional upward pressure on inflation.
- o The large debt burden of the developing countries could cause a sharp decline in world trade and, hence, in world output and growth. This is discussed in Chapter II.

ALTERNATIVE ECONOMIC PATHS AND BUDGET ESTIMATES

To highlight the uncertainty in the economic outlook, two alternative growth paths for the economy through 1988 are presented in Table 10 and in Figure 15. The "high" path assumes more real growth, lower interest rates, lower unemployment, and somewhat higher inflation. Real GNP grows at approximately the rate of a normal post-World War II cyclical recovery in the first three years. Thereafter, real growth continues at 4 percent

Figure 15.
CBO Baseline Economic Projections and Alternatives



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

NOTE: Potential GNP is computed on the basis of a 6 percent unemployment rate (see Chapter IV).

annually. Inflation, as measured by the GNP deflator, averages 4.9 percent a year from 1983 to 1988, and the unemployment rate drops to 6.0 percent in that year. The "low" path, on the other hand, assumes lower real growth, higher interest rates, higher unemployment, and lower inflation. The growth rate of real GNP averages 2.8 percent a year over the 1983-1988 period, inflation averages 4 percent, and unemployment drops only to 9 percent by 1988.

The top panel of Figure 15 presents the three GNP paths relative to a hypothetical GNP path that has been standardized to 6 percent unemployment over the projection period. 1/ As can be seen in the figure, the economy is still operating with substantial excess capacity by 1988 along the baseline projection path. With the high path, the economy finally crosses the potential GNP path at the end of the period; with the low path, however, the gap is closed only slightly. The second panel of the figure tells essentially the same story in terms of movements in the unemployment rate. Along the low path, the unemployment rate remains very high throughout the period. Only with the high path does the unemployment rate move down to the 6 percent rate that some analysts believe is "full employment." The third panel of the figure presents the alternative paths of inflation thought to be consistent with the projected paths of output. The paths vary only slightly--in sharp contrast to the jagged historical path--because no price shocks are assumed. In the high path, the rate of inflation remains essentially unchanged at about 5 percent, whereas in the low path it drops to around 3 percent. 2/

Estimates of federal revenues, outlays, and deficits based on the three paths are shown in Table 10. In each case the budget policies are the tax and spending programs in effect at the end of the 97th Congress, with defense spending in 1984 at the level specified in the 1983 resolution. Under the CBO baseline assumptions, receipts fall faster relative to the level of GNP than do outlays, and the deficit continues to rise. Over the 1985-1988

1/ The capital stock underlying this hypothetical path is that presumed in the baseline. Under the high growth path, stronger investment will raise the capital stock relative to the baseline and thus the economy's capacity to produce output at an unemployment rate of 6 percent.

2/ Many analysts would argue that the low path would lead to widespread business failures both here and abroad, with substantially lower inflation than that shown in the low path. Similarly, many believe that there would be a greater acceleration of inflation in the high path, particularly if it were the result of an expansive monetary policy.

TABLE 10. BASELINE BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC PATHS (By fiscal year, in billions of dollars, unified budget basis)

	1982	1983	1984	1985	1986	1987	1988
Revenues							
High Path	618	615	676	743	798	862	933
Baseline	618	606	653	715	768	822	878
Low Path	618	599	637	686	730	777	825
Outlays							
High Path	728	793	830	904	971	1041	1116
Baseline	728	800	850	929	999	1072	1145
Low Path	729	804	868	958	1032	1110	1187
Deficit							
High Path	111	178	155	162	172	179	183
Baseline	111	194	197	215	231	250	267
Low Path	111	205	232	272	302	333	363

Memo: Deficits as a Percentage of GNP							
High Path	3.7	5.5	4.3	4.1	4.0	3.8	3.6
Baseline	3.7	6.1	5.6	5.6	5.6	5.6	5.6
Low Path	3.7	6.5	6.8	7.4	7.6	7.9	8.1

period, the deficit averages about 5½ percent of GNP. Under the high growth path, revenues rise above the baseline because of higher real growth and inflation. Outlays fall because of the lower unemployment rate, lower interest rates, and lower cumulative deficits. ^{3/} In dollar terms, the deficit remains stubbornly high throughout the period, although as a percent of GNP it falls to about 3½ percent. The low path produces effects on revenues and outlays in the opposite direction, and the deficit rises dramatically. By

^{3/} The higher inflation raises outlays, but not by enough to offset the impact of the other changes in the economy.

1988, it is estimated to be over 8 percent of GNP--substantially above the postwar record rate estimated for the current fiscal year.

There is no guarantee that the tax and spending estimates will prove consistent with the path of the economy as shown in the baseline and alternative outyear projections. Interactions between changes in interest rates and fiscal policy, for example, are very important but difficult to project. The feedback of international developments on the economy stemming from changes in credit conditions is also hard to anticipate. Nevertheless, the qualitative story told by these estimates--that the deficit will remain very high, given any reasonable growth path--seems incontrovertible.

CHAPTER IV. FISCAL AND MONETARY POLICY

High interest rates played a major role in bringing on the recession; they will likely be a major determinant of how fast the economy recovers and how long the recovery lasts. But interest rates depend heavily on fiscal and monetary policies, and the outlook for both of these is clouded with uncertainty. Large and increasing federal deficits threaten to raise interest rates during the recovery, and it is as yet unclear what measures will be taken to reduce them. Monetary policy is also an important factor, but the Federal Reserve has not indicated what course it will take in the months and years ahead. Some analysts believe that this uncertainty about fiscal and monetary policies is placing upward pressure on long-term interest rates and contributing to current weakness in the economy.

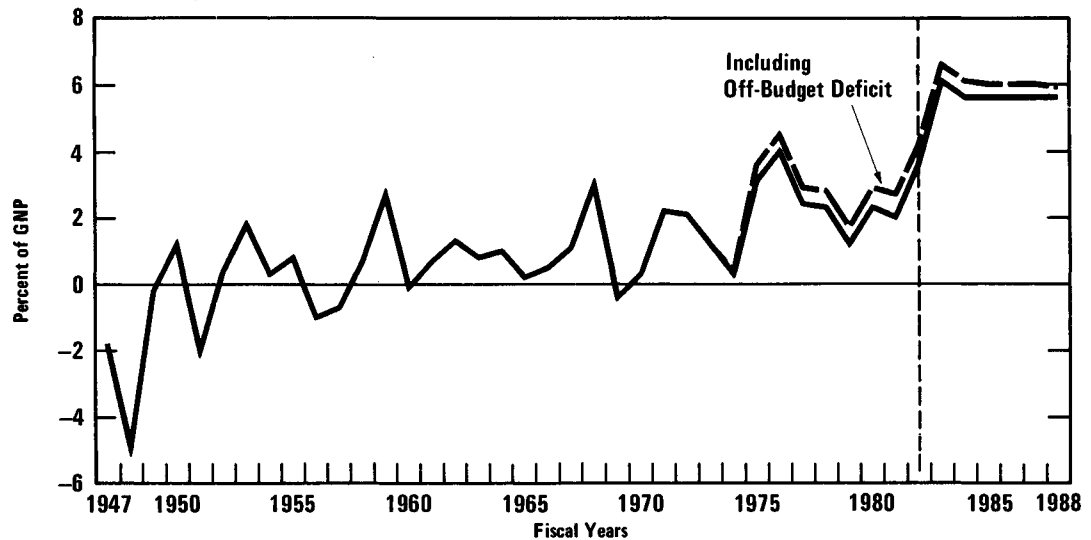
Proposals to reduce the federal deficit in the current year and in 1984 are opposed by many economists on the ground that to do so would slow recovery. Most agree, however, that deficits in later years should be reduced in order to keep federal borrowing from crowding out private investment. There is less agreement about monetary policy. Some advocate an expansive monetary policy to avoid a financial crisis, reduce interest rates, and encourage economic recovery. Others fear that this would cause a resurgence of inflation. The disagreement reflects issues of fact, such as the relationship between money growth and inflation, and also value judgments concerning the relative cost to society of inflation and unemployment. Administration and Federal Reserve spokesmen have indicated that their goal is a moderate recovery, consistent with a decline in unemployment and further reduction in the inflation rate. This may be a difficult task. Recent experience has shown, once again, that macroeconomic policies that reduce inflation also cause unemployment, at least in the short run. Thus, the difficult choice is whether to give greater emphasis to reducing unemployment or to fighting inflation.

This chapter examines the outlook for the federal deficit, monetary aggregates, and interest rates. Together with the next chapter, it discusses options open to the Congress and the Federal Reserve in determining policy for the period ahead.

FISCAL POLICY

The federal deficit is expected to reach a record high of \$194 billion in fiscal year 1983 and, unless budget policies are altered, it will continue to rise during the next five years to \$267 billion, according to CBO projections.

Figure 16.
Unified Budget Deficit as a Percent of GNP



SOURCES: Office of Management and Budget, U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

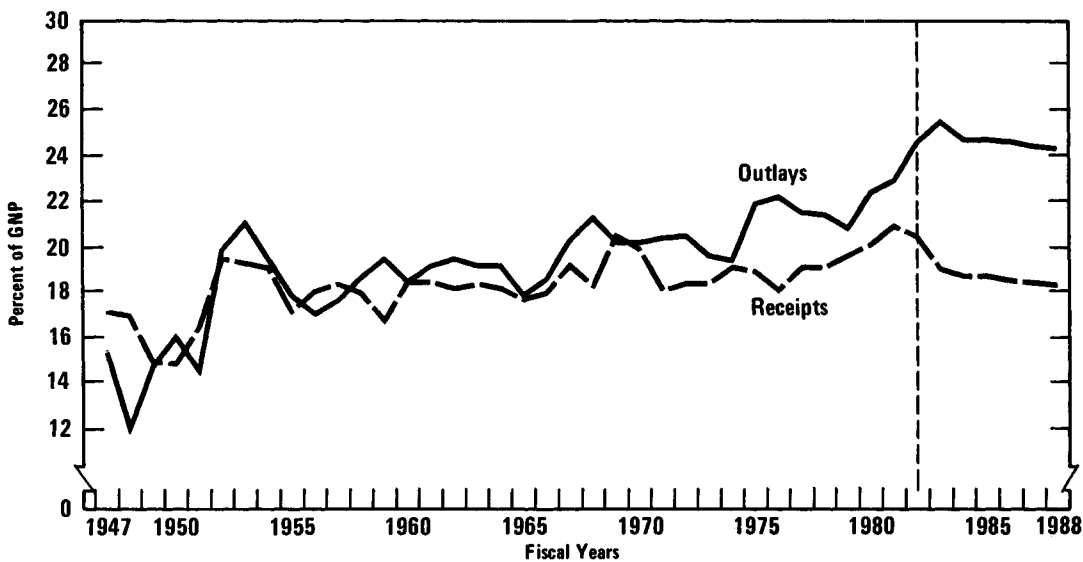
Most economists agree that a continually rising deficit, when economic slack has been greatly reduced, would be inappropriate because the need to finance such large deficits would draw funds away from business investment, and thereby reduce long-run economic growth. Given the current state of the economy, however, it is debatable whether the Congress should try to reduce significantly the 1983 and possibly the 1984 deficits, because it might endanger the recovery. The same argument does not apply to the 1985-1988 deficits, however.

The Economic Implications of Rising Deficits

The sharp rise in the deficit in 1982 and again this year in part reflects budget policies, particularly the recently enacted tax cuts and the rise in defense spending. However, roughly two-thirds of the 1983 deficit appears to be the result of economic slack. Although a weak economy accounts for most of the deficit in the current year, the deficit is not projected to decline as usual during the recovery. In fact, given the CBO baseline economic projections, the deficit will continue rising at least through 1988, assuming no change in budget policies now in place. Moreover it does not decline relative to GNP in the 1984-1988 period (see Figure 16).

Figure 17.

Unified Budget Receipts and Outlays as a Percent of GNP



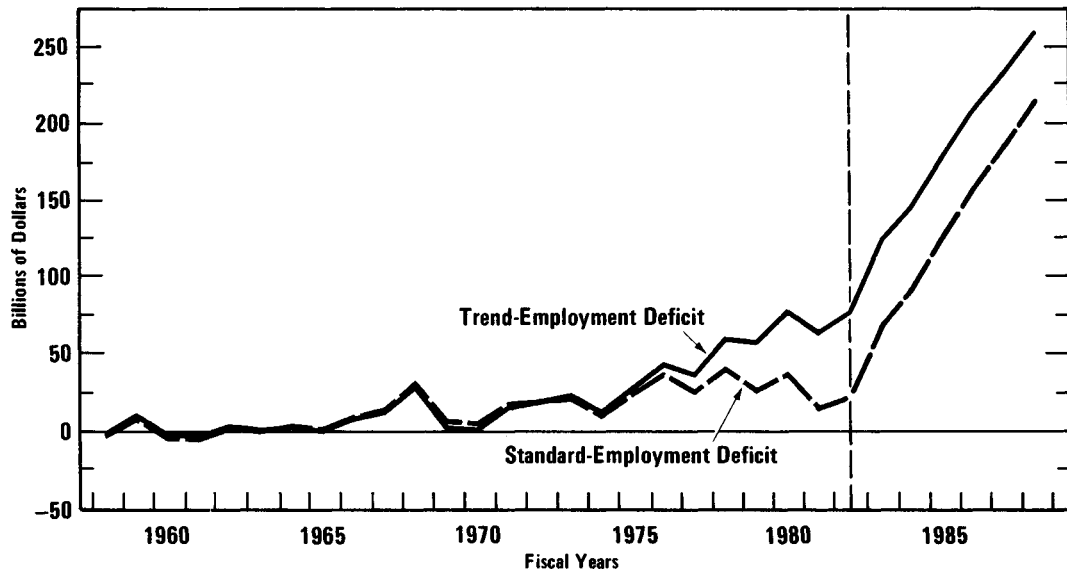
SOURCES: Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

This is because major changes have occurred in tax and expenditure policies. Federal spending as a proportion of GNP remains very high by historical standards--higher than in any postwar year before 1982 (see Figure 17)--largely because of the build-up in defense spending, rising interest payments, and the growth of entitlement programs. At the same time, revenues show a relative decline from 20.9 percent of GNP in 1981 to 18.3 percent in 1988--the third lowest ratio since 1966--largely because of the Economic Recovery Tax Act of 1981.

One way to measure the impact of policy changes on the budget is to estimate what the deficit would be if unemployment remained at a fixed rate. Changes in the resulting "standard-employment" budget isolate the effects of policy actions, because the impacts of changed economic conditions are largely removed. ^{1/} Such calculations show that

^{1/} When measured at high rates of resource utilization, this concept is often called the high-employment budget.

Figure 18.
Standard-Employment and Trend-Employment Deficits
(Unified Budget Basis)



SOURCE: Congressional Budget Office.

fiscal policies, rather than economic conditions, account for a growing proportion of the budget deficit in outyears. According to CBO estimates, unless policies in place are changed, the standard-employment budget deficit will rise from \$23 billion in fiscal year 1982 to \$215 billion in fiscal year 1988 (see Table 11). By this measure, fiscal policy would provide a near record dose of sustained stimulus in the 1984-1988 period (see Figure 19).

The magnitude of the budget stimulus is also illustrated by CBO's high-growth path projections shown in the preceding chapter. This "optimistic" projection assumes an average postwar recovery, in addition to lower interest rates and higher inflation than CBO uses in the calculations of the standard employment budget. But even in this optimistic projection, the deficit remains very high, \$183 billion in fiscal year 1988.

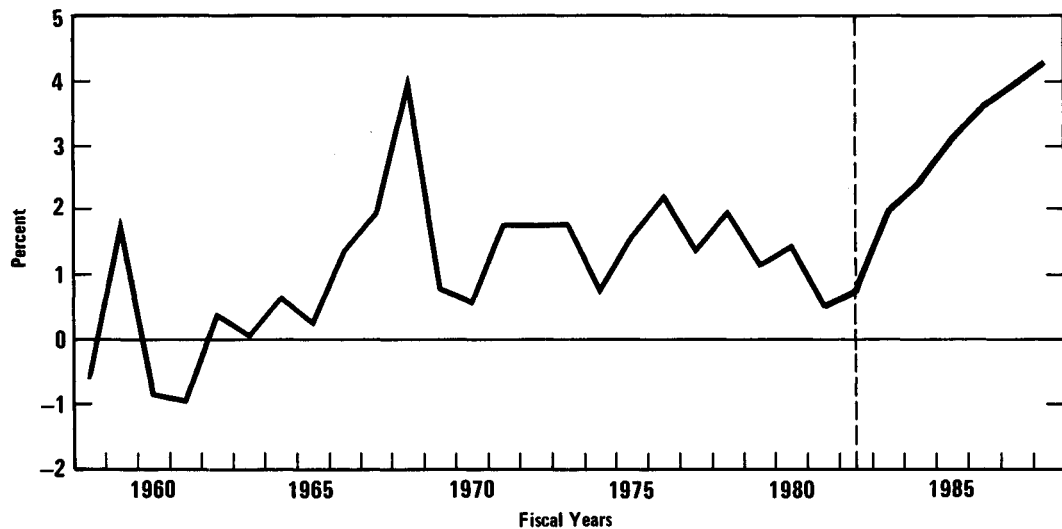
TABLE 11. THE BUDGET OUTLOOK, FISCAL YEARS 1983-1988

	Actual Estimated		Projections				
	1982	1983	1984	1985	1986	1987	1988
In Billions of Dollars							
Unified Budget Deficit	111	194	197	214	231	250	267
Revenues	618	606	653	715	768	822	878
Outlays	728	800	850	929	999	1072	1145
Off-Budget Deficit	17	17	15	16	19	17	17
Total Federal Deficit <u>a/</u>	128	210	212	231	250	267	284
Standard-Employment Deficit <u>b/</u>	23	69	91	128	159	187	215
Publicly Held Debt	929	1128	1340	1571	1820	2087	2372
As a Percent of GNP							
Unified Budget Deficit	3.6	6.1	5.6	5.6	5.6	5.6	5.6
Revenues	20.4	19.0	18.7	18.7	18.5	18.4	18.3
Outlays	24.0	25.0	24.3	24.3	24.1	24.0	23.9
Standard-Employment Deficit (Percentage of Standardized GNP) <u>b/</u>	0.7	1.9	2.4	3.1	3.6	4.0	4.3

a/ Defined as the sum of the unified budget and off-budget deficits.

b/ Unified budget basis, calculated at 6 percent unemployment, with 2.6 percent average growth in the corresponding level of GNP during the 1983-1988 period.

Figure 19.
Standard-Employment Deficit as a Percent of Standardized GNP
(Unified Budget Basis)



SOURCE: Congressional Budget Office.

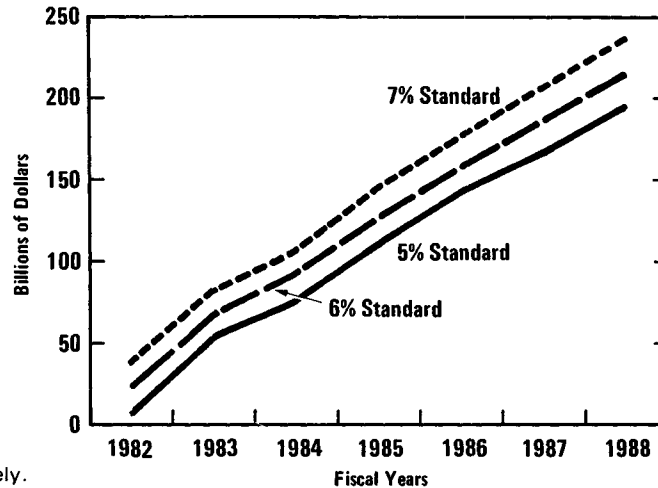
NOTE: Forecast standardized at 6 percent unemployment.

Many economists believe that fiscal stimulus in the current year, and possibly in 1984, should not be significantly reduced because to do so might inhibit the recovery. But the outyear budget deficits could have adverse effects if the economy is operating at high levels of output. Such stimulus could clash with anti-inflationary monetary policy. The prospect of such large deficits may also be a factor in current high long-term interest rates. If so, they may already be impeding the growth of housing starts and the purchases of consumer durables--important to economic recovery. Later, these deficits are also likely to crowd out business investment--a primary source of long-run economic growth.

Figure 20.
Alternative Standard-
Employment Deficits
(Unified Budget Basis)

SOURCE: Congressional Budget Office.

NOTE: These alternatives differ by the level of employment and output used to standardize the budget. The "5% standard" is the same as the "full-employment budget" concept, and currently assumes 5 percent unemployment. The "6% standard" and "7% standard" assume one percentage point and two percentage points higher unemployment, respectively.



Alternative Guidelines for Deficits

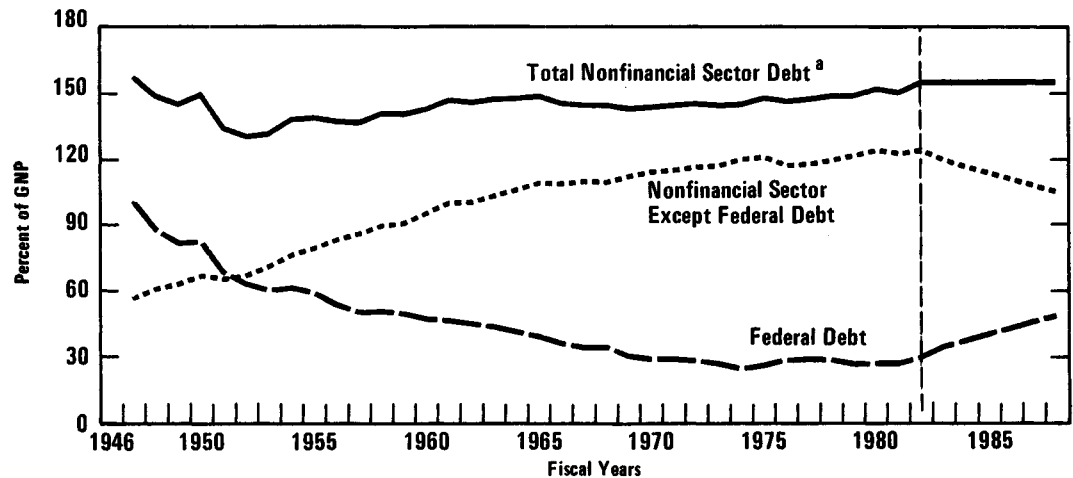
How much do future deficits have to be reduced to avoid the adverse effects on the economy mentioned above? Because a balanced budget does not appear to be an attainable or desirable goal during the next few years, some other norm or guideline would be useful.

One possible norm would be a balanced standard-employment budget. With this standard, the size of the deficit reductions would depend somewhat on the constant rate of unemployment chosen for the calculation. For example, with a constant 6 percent unemployment rate, the standard-employment deficit would be \$215 billion in fiscal year 1988. By comparison the deficit would be \$196 billion if a constant 5 percent unemployment rate were used, and \$235 billion, if a constant 7 percent unemployment rate were chosen (see Figure 20).

A different approach would involve balancing the budget over the course of the business cycle. This would require balancing the budget at trend or average levels of employment and output. The trend-employment deficit, which is generally higher than the standard-employment deficit,

Figure 21.

Outstanding Debt of Nonfinancial Sectors



SOURCES: Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

^a Assumed to be constant percent of GNP from 1982 to 1988.

is estimated to rise to \$261 billion by fiscal year 1988, with policies now in place (see Table 12).

There are several other possible standards. One norm that has recently received attention would involve eliminating the "primary deficit," estimated to be \$163 billion in fiscal year 1988. (The primary deficit is the budget deficit plus off-budget deficit, excluding net interest payments and Federal Reserve payments to the Treasury.) It can be shown that eliminating the primary budget deficit would lead to a declining trend in the federal debt-GNP ratio, as long as the effective interest rate is less than the rate of growth of GNP. ^{2/} Historical experience suggests that this standard would likely permit a rise in private borrowing relative to GNP and

^{2/} James Tobin, "Budget Deficits, Federal Debt, and Inflation In Short and Long Runs," paper presented at a Conference Board meeting, "Toward a Restructuring of Federal Budgeting," Washington, D.C., December 2, 1982.

TABLE 12. ALTERNATIVE STANDARDS FOR REDUCING THE DEFICIT
(By fiscal year, in billions of dollars)

Alternative Standards	1984	1985	1986	1987	1988
Deficit to be Eliminated					
Standard-Employment Deficit <u>a/</u>	91	128	159	187	215
Trend-Employment Deficit <u>b/</u>	146	181	209	235	261
Primary Deficit <u>c/</u>	129	136	145	154	163
Structural Primary Deficit <u>d/</u>	31	55	77	94	113

SOURCE: Congressional Budget Office.

a/ Unified budget standardized at 6 percent unemployment.

b/ Unified budget standardized at trend employment.

c/ Unified budget plus off-budget deficits, excluding net interest payments and Federal Reserve payments to the Treasury.

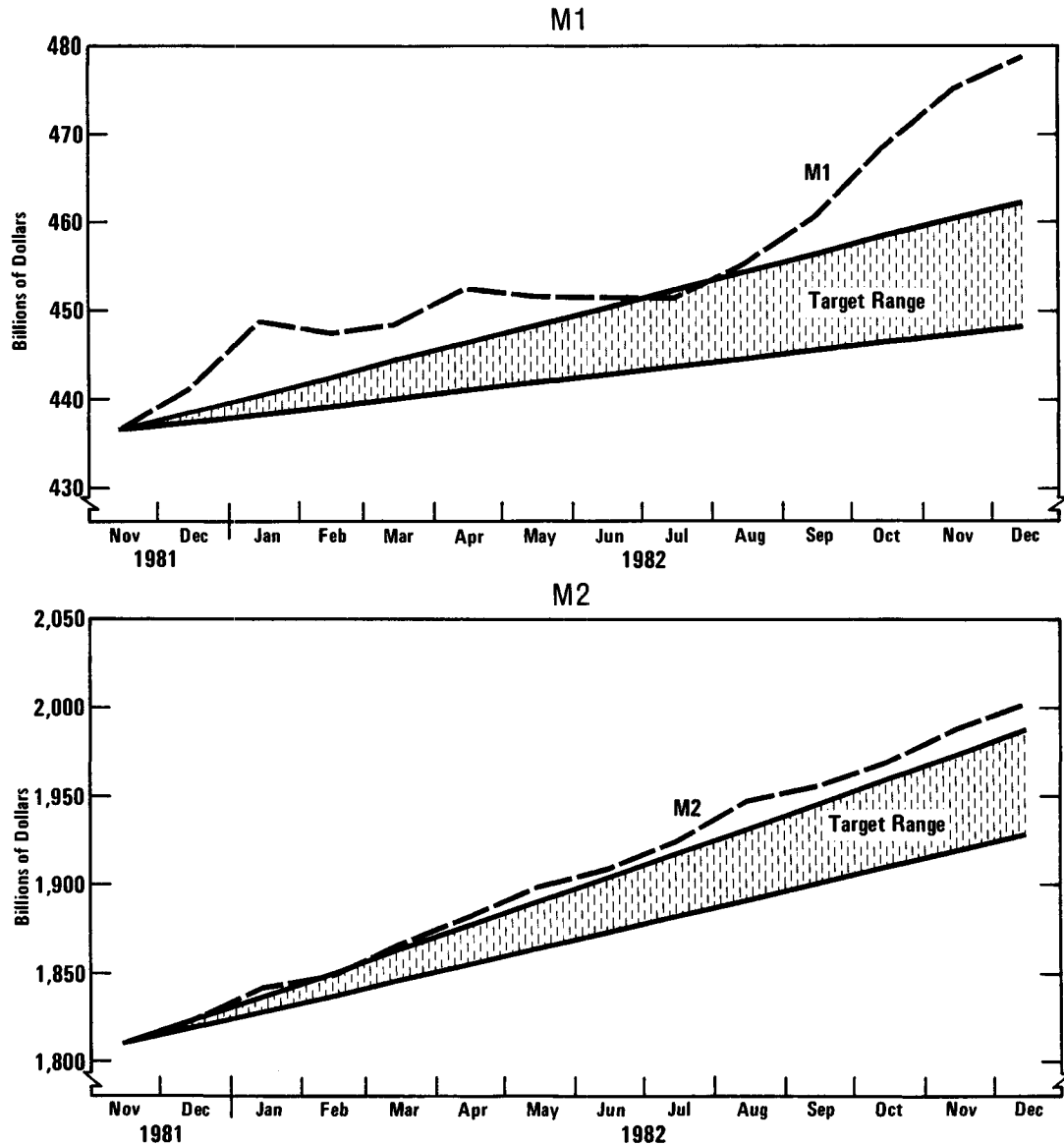
d/ Primary deficit standardized at 6 percent unemployment.

thereby improve prospects for business investment (see Figure 21). Alternatively, the primary budget could be balanced at a constant unemployment rate. At a 6 percent unemployment rate, this would require a \$113 billion reduction in the deficit in 1988. With this rule, the federal debt-GNP ratio would not reach a declining trend until after 1988.

By any of these standards, the task confronting the Congress is formidable. To eliminate the noncyclical or structural component of the 1988 deficit (standardized at 6 percent unemployment) would require deficit reductions amounting to \$113 billion to \$215 billion depending on the treatment of interest payments and other factors. Major reforms in both tax and spending structures would be necessary to achieve such goals. No major tax or spending program could be excluded from the process without making the task more difficult and imposing an additional burden on beneficiaries of other programs.

Figure 22.

M1 and M2 Levels and Targets in 1982



SOURCE: Federal Reserve Board.

NOTE: M1 consists of currency in circulation, travelers' checks, checking accounts, and other checkable deposits at depository institutions. The target growth range for 1982 was 2½ to 5½ percent.

M2 consists of M1 plus savings and small time deposits at depository institutions, money market mutual fund shares, and some overnight repurchase agreements and Eurodollar deposits. The target growth range for 1982 was 6 to 9 percent.

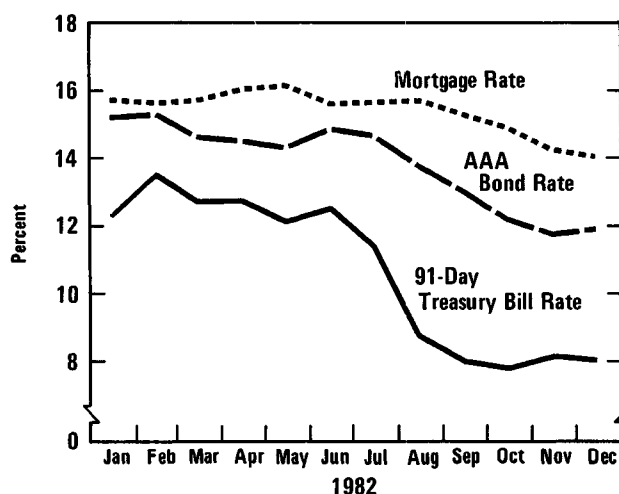
Although smaller deficits would entail a reduction in fiscal stimulus, they could be achieved gradually over time without endangering the recovery. Policies that reduce deficits in later years are likely to result in easier credit conditions and faster economic growth if monetary policy accommodates it. Many economists regard a policy mix combining fiscal restraint with some monetary policy accommodation as the one most conducive to investment and long-run economic growth.

MONETARY POLICY AND FINANCIAL CONDITIONS

How restrictive has monetary policy been during the past year? The evidence is mixed. On the one hand, the money supply by various definitions grew relatively fast, at rates well above the Federal Reserve's target range (see Figure 22). The growth in M1, sometimes regarded as the most important indicator of monetary policy, was especially rapid late in the year, suggesting that monetary policy was not restrictive. The behavior of interest rates indicates otherwise, however. Rates of all maturities were extremely high during much of the year (see Figure 23). Real interest rates were by some measures at their highest levels since the Depression.

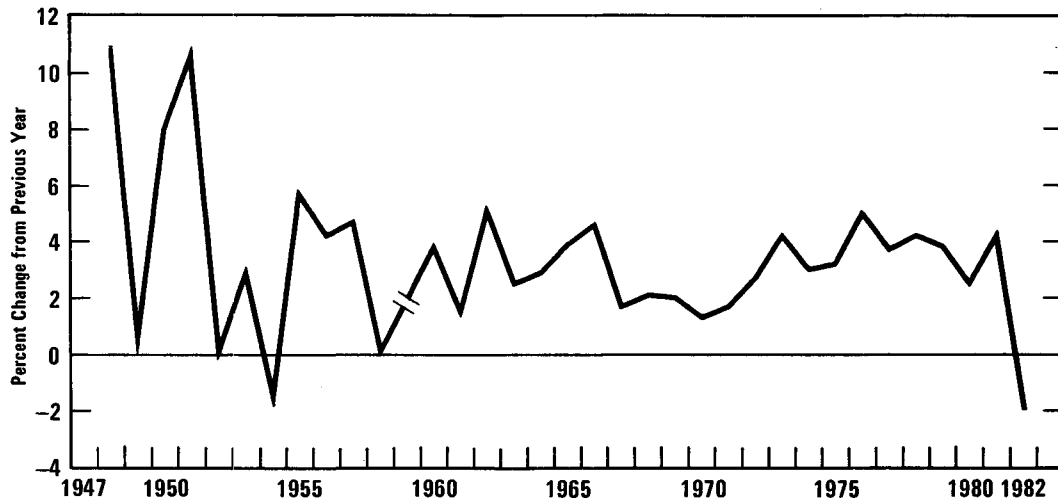
This combination of strong growth in the money supply with high interest rates reflects unusual developments in financial markets. The Federal Reserve apparently believes that people have shifted wealth into monetary assets as a reaction to recent and expected economic and financial developments, and not as a means of financing current purchases. If this is so, the increase in the money supply growth has largely reflected

Figure 23.
Interest Rates



SOURCES:
Federal Home Loan Bank Board;
Moody's Investor Services; Federal
Reserve Board.

Figure 24.
M1 Velocity Growth



SOURCES: Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: M1 was redefined in 1959.

an increase in the demand for money assets, and has not been a net stimulus to the economy. ^{3/}

Money and "Velocity" in 1982

The unusual relationship of recent money demand to the course of the economy is reflected in the behavior of money "velocity." Velocity, the ratio of GNP to the money supply, measures the number of times on average that each dollar in the money supply is used in a transaction included in GNP during the year. As Figure 24 shows, M1 velocity declined during 1982 for the first time since 1954--a marked departure from its historical growth trend. This implies that individuals and businesses were accumulating money holdings for purposes other than spending during 1982. Money growth served largely to finance the accumulation of idle balances rather than the growth of GNP.

^{3/} Congressional Budget Office, The Economic and Budget Outlook: An Update (September 1982), pp. 46-49.

TABLE 13. GROWTH OF SELECTED COMPONENTS OF M1 AND M2, 1979-1982 (Percent change, fourth quarter to fourth quarter)

	M1		M2		
	Currency	Demand Deposits	Other Checkable Deposits (Primarily NOW Accounts)	Savings Deposits	Small Time Deposits
1979	9.5	3.0	142.6	-11.8	22.7
1980	9.3	3.2	59.0	-4.6	14.5
1981	5.6	-12.6	183.7	-16.3	15.9
1982	8.0	1.0	33.7	8.9	7.4

SOURCE: Federal Reserve Board.

The outlook for the economy in the next months depends critically on whether velocity rebounds or continues behaving sluggishly. At present, it is not known which of these two possibilities is more likely because no one understands exactly why velocity has behaved the way it has. One view is that individuals and firms have been adjusting their money holdings in response to a reduction in inflationary expectations. This hypothesis is (1) difficult to test because inflationary expectations are hard to measure; and (2) difficult to reconcile with the fact that recent increases in money holdings have been concentrated in one component of the money supply, NOW accounts (see Table 13). (This view of the cause of the increase in money holdings provides no reason to expect the increase to be concentrated in one component instead of being spread over all of them.) If the expectations view is correct, velocity may not snap back to its earlier level, but it could begin growing at trend rates again as soon as the adjustment in inflationary expectations is complete.

An alternative view argued by some economists and supported by Federal Reserve studies is that households tend to increase the share of

Money Demand

In its September economic report, the CBO presented evidence on current money demands from three statistical equations designed to predict the level of money holdings. These equations consistently underestimated the amount of money that agents in the economy were holding in 1982. The underpredictions were by amounts large enough to warrant a firm inference that money demand in 1982 did not reflect the same factors that underlie the estimated equations. The CBO has subsequently updated these estimates using later data, and found that the same conclusions can be drawn. The table below shows the amounts by which two of the money-demand equations underpredicted money holdings during the four quarters of 1982. The errors for the first three quarters are roughly the same as those reported earlier, while that for the fourth quarter is much larger.

AMOUNTS BY WHICH TWO STATISTICAL MONEY-DEMAND
EQUATIONS UNDERESTIMATE THE LEVEL OF
THE MONEY STOCK (M1), 1982:1 TO 1982:4
(Billions of dollars)

	<u>Error</u>		Actual Money Stock
	Goldfeld	Hamburger	
1982:1	9.5	8.3	448.1
1982:2	10.1	8.7	451.8
1982:3	8.0	8.8	455.7
1982:4	20.2	20.7	474.0

SOURCE: Computations described in Congressional Budget Office, The Economic and Budget Outlook: An Update (September 1982), pp. 79-85, and in this text.

their wealth held in interest-bearing liquid forms, such as NOW accounts, when the unemployment rate rises. ^{4/} The view that recent increases in money demand reflect this precautionary motive is therefore consistent with the fact that the increase is concentrated in NOW accounts. If this overall explanation is correct, velocity may begin to grow strongly once an economic recovery is under way. If velocity rebounds then the money growth currently tolerated by the Federal Reserve could suddenly become highly stimulative to the economy.

The uncertainty about the behavior of velocity clouds the outlook for the economy. As the discussion of fiscal policy has already shown, however, this is only one of several sources of serious uncertainty regarding the recent and prospective course of the economy.

Recent Behavior of Interest Rates

Many explanations have been advanced for the persistently high levels of interest rates. Some have emphasized the fact, discussed in this chapter, that money demands have been quite strong relative to the supply made available by the Federal Reserve, and that current and prospective federal budget deficits are extraordinarily high. Still other explanations have centered on expectations of future inflation or monetary restraint. ^{5/}

It appears that several of these factors were working at once to sustain high interest rates during the first half of 1982. When rates finally moved downward in midsummer, however, a relaxation of monetary restraint seems to have been largely responsible, together with the enactment of a deficit-reducing fiscal package.

Interest rates began declining in July, following a reduction in the Federal Reserve discount rate and the release of the Board's midyear report. The report, and the accompanying testimony, stated that the central bank would not necessarily enforce its monetary targets during the remainder of

^{4/} The fact that the velocity decline has few precedents is, according to this view, explained by the fact that the narrow supply has contained an interest-bearing component only since NOW accounts were introduced nationwide in 1981.

^{5/} For a detailed discussion of recent interest rates, see CBO, The Economic and Budget Outlook: An Update, pp. 39-46.

the year as long as strong money demands unrelated to the growth of economic transactions persisted. 6/ The resulting sense that interest rates would be allowed to move lower was reinforced when influential Wall Street forecasters began predicting lower rates, and when the Federal Reserve announced formally that its M1 targets were being suspended.

The reason it gave for suspending its targets was the fact that the growth of M1 was expected to be significantly distorted by the pending expiration of large quantities of All-Savers' Certificates. The expected introduction of "Money-Market" and "Super-NOW" accounts at banks and thrift institutions seemed likely to compound these problems. While these distortions are real, many observers discounted the stated reasons for the change, concluding instead that the targets were being abandoned primarily in order to give the authorities freedom to stimulate the economy. This uncertainty about the central bank's intentions has persisted, and may be having a significant impact on interest rates. The topic receives more discussion below. 7/

Economic Impact of the Drop in Rates

A number of circumstances prevented the drop in interest rates from causing a quick and strong turnaround in economic activity. Even under the best conditions, financial changes require several months before their effects are felt. It may also be that the levels of interest rates were still too high to generate a recovery. Both short- and long-term rates fell noticeably (see Table 14). Long rates, however, remained at double-digit levels, and most observers believed that the underlying real levels of both short and long rates were still very high. This is demonstrated in Figure 3, which shows the course of one measure of real short-term rates since 1950. The inflation-adjusted Treasury bill rate was higher at the end of 1982 than at any time in recent years except early 1981, just before the current recession began.

It is difficult to develop measures of real long-term rates. (Doing so requires subtracting a measure of expected inflation over the life of a given

6/ Board of Governors of the Federal Reserve System, Midyear Monetary Policy Report to Congress Pursuant to the Full-Employment and Balanced Growth Act of 1978 (July 20, 1982), p. 19.

7/ Another factor in last summer's break in rates may have been an inflow of funds from abroad caused by a sudden increase in fears about the solvency of many foreign governments. This argument is hard to verify, however, because the evidence on such flows is mixed.